1993

Information Needs of Investors and Creditors: A Report on the AICPA Special Committee's Study of the Information Needs of Today's Users of Financial Reporting

American Institute of Certified Public Accountants. Special Committee on Financial Reporting

The Information Needs of Investors and Creditors

A Report on the AICPA Special Committee's Study of the Information Needs of Today's Users of Financial Reporting

The AICPA Special Committee
on Financial Reporting

November 1993

About the AICPA Special Committee on Financial Reporting

The Special Committee on Financial Reporting was formed in the spring of 1991 by the AICPA Board of Directors to address increasing concerns about the relevance and usefulness of financial reporting. The Committee's specific charge is to recommend (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information.

The focus of the Committee's work is on the information needs of investors and creditors, and its recommendations will be responsive to those needs. As the Committee develops recommendations, it is considering possible changes in the format, presentation and communication of information and possible structural changes in the financial reporting process that may be required to permit implementation of its recommendations. In developing its recommendations, the Committee will be mindful of cost-benefit considerations, including competitive and legal concerns.

The Committee is not a standard-setting body. Its recommendations will be submitted to the AICPA Board of Directors. If subsequently acted on by standard setters or regulators, these recommendations will be subject to due process.

About the Study

Since its formation, the Special Committee has conducted extensive research to determine the information needs of today's users of financial reporting. That research has focused on professional investors and creditors and their advisors who use financial reports in their decision-making processes and who cannot compel a company to produce the information needed for their analysis. The Committee's effort to learn directly from users the information they need to make investment and credit decisions, rather than inferring from what others -- accountants, preparers or academics -- believe they need, has been unique and important.

The Committee's research activities have included:

-- *Study and analysis of the writings of investors and creditors and the writings of others about their research into the information needs of investors and creditors.*

-- *Study and analysis of the types of information included in analysts' formal reports about companies.*

-- *Meetings with discussion groups formed by the Committee that included portfolio managers, analysts and bankers from large and small institutions.*

-- *Meetings with the Financial Accounting Policies Committee of the Association for Investment Management and Research and the Accounting Policies Committee of Robert Morris Associates.*

-- *Informal meetings with other investors and creditors.*

Users of financial information are a diverse group with diverse information needs. This report presents a synthesis of users' views gathered by the Committee as a result of its research.

Information is central to the operation of effective capital markets. Financial reporting has the unique role of reducing the risks and uncertainties that investors and creditors must deal with by providing relevant and reliable information about transactions and events.

Over time, a financial reporting process that fails to meet the information needs of investors and creditors results in less effective capital markets. Uninformed markets misallocate and misprice capital -- to the detriment of almost everyone.

Introduction

Investment and credit decision making based on information that is less than timely, relevant and reliable inevitably leads to unfulfilled expectations about financial reporting and less effective capital markets. Although investors and creditors have said that today's financial reporting system generally provides information that is useful in their decision making, they also have said that some of their critical information needs are not being met. Recognizing that the rate of change in the reporting environment is accelerating, investors and creditors want financial reporting that provides better indicators of future financial performance -- and they want fewer surprises.

Past efforts to address the financial reporting implications of a changing business environment have been productive and informative, but consensus on what changes are needed has proved extremely difficult to achieve. In addition, none of the efforts in the past has focused comprehensively on the needs of the users. A new coordinated approach to change is needed -- an approach grounded in and responsive to users' needs.

Unless the future of financial reporting and the information needs of users are addressed broadly and systematically, preparers, auditors, professional organizations, standard setters and regulators will be compelled to continue to develop ad hoc solutions to problems as they arise. Meanwhile, important issues will remain unresolved, and the usefulness and credibility of financial reporting will decline. Moreover, in today's litigious environment, some solutions may be subject to legal challenges that could prove costly.

The AICPA has made a public commitment to improved financial reporting and formed the Special Committee to respond to that commitment.

HIGHLIGHTS OF

Although the users of financial reporting are a diverse group with diverse information needs, a commonality of views is evident on the following topics.

VALUE INFORMATION

Users oppose replacing the current historical cost-based accounting model with a fair value accounting model. However, they view fair value information as useful for particular types of assets and liabilities and in certain types of industries.

DISAGGREGATED INFORMATION

Both investors and creditors place a high value on segment reporting and believe that current disaggregated disclosures generally do not provide adequate information to help them predict an entity's future earnings and cash flows. They also want segment information on a quarterly basis.

CORE EARNINGS

Users want information about the portion of a company's reported earnings that is stable or recurring and that provides a basis for estimating sustainable earnings.

ESTIMATES, ASSUMPTIONS AND OFF-BALANCE-SHEET RISKS

Users want companies to disclose information about the estimates and assumptions used to determine material asset and liability amounts. They also want more qualitative and quantitative information about the risks associated with financial instruments and off-balance-sheet financing arrangements.

THE STUDY

NONFINANCIAL BUSINESS INFORMATION

Users need to understand the relationship between the events and activities of a company and how those events and activities are reported in its financial statements. Nonfinancial business information serves the critical function of helping users understand that relationship as they evaluate a company's operations.

FORWARD-LOOKING INFORMATION

Investors and creditors need forward-looking information on which to base their own projections. But they do not expect management to provide projections or forecasts. They also want more information about operating opportunities and risks that are relatively near-term and relatively certain and quantifiable.

CONSISTENCY AND COMPARABILITY

Information about a company that is consistent over time is valued more highly than information that is comparable between two or more companies -- but both are significant.

CREDIBILITY

Credibility of reporting is a serious problem. Investors, creditors and their advisors believe that the reports of many companies reflect the natural tendency of management to report information in the best possible light and to avoid reporting poor company performance.

THE ROLE OF AUDITING

Users believe audited information has value because auditors provide independent assurance of the reliability of amounts reported and accompanying disclosures. They would like auditors to provide additional qualitative commentary in their reporting.

Users oppose replacing the current historical cost-based accounting model with a fair value accounting model. However, they view fair value information as useful for particular types of assets and liabilities and in certain types of industries.

Users say the current historical cost-based model provides them with a stable and consistent benchmark that they can rely on to establish historical trends. They are concerned about the subjectivity and potential volatility in reported results of a model based on fair value, and they are not convinced that the benefit is worth the cost when fair values are not readily determinable.

When fair value information is disclosed, users want to know the assumptions underlying the fair value estimates so they can assess the reasonableness of the amounts and the consistency of the estimation method from period to period.

Both investors and creditors place a high value on segment reporting and believe that current disaggregated disclosures generally do not provide adequate information to help them predict an entity's future earnings and cash flows.

They also want segment information on a quarterly basis.

Users believe segments of an entity's business that have significantly different opportunities and risks should be disaggregated and disclosed separately in the financial statements. They want disaggregated information presented in a manner consistent with the way the entity manages its risks and opportunities, even if the company is not managed on an industry basis. In certain instances, users also want disaggregated information on a geographic and line-of-business basis.

Users want information about the portion of a company's reported earnings that is stable or recurring and that provides a basis for estimating sustainable earnings.

Current financial reporting does not separately display core earnings, and users do not believe the system provides sufficient information about nonrecurring, unusual or infrequent items to enable them to determine core earnings for themselves. They believe that financial statements do not identify a sufficiently broad range of potential nonrecurring, unusual or infrequent items and that the descriptions and details of items identified are sometimes insufficient to determine whether they are part of core earnings.

Users want companies to disclose information about the estimates and assumptions used to determine material asset and liability amounts.

They also want more qualitative and quantitative information about the risks associated with financial instruments and off-balance-sheet financing arrangements.

Users believe that companies should disclose information about estimates and assumptions because that information is essential to the evaluation of the uncertainties inherent in the financial statements.

They also want more useful information about financial instruments and off-balance-sheet financing arrangements to understand the nature of the various risks undertaken by a company. In the current environment that might include information about:

-- Hedging strategies.

-- Sensitivity analyses based on changes in interest and foreign exchange rates.

-- The risks related to derivative products (swaps, futures contracts, etc.), particularly credit and counterparty risks.

Users need to understand the relationship between the events and activities of a company and how those events and activities are reported in its financial statements. Nonfinancial business information serves the critical function of helping users understand that relationship as they evaluate a company's operations.

Users are interested in nonfinancial business information about a company and its segments, such as:

-- Mission and objectives, methods of conducting the business and its relationships with others -- for example, financial interests and relationships among major shareholders, directors and management and between them and the company.

-- Nonfinancial operating data, such as production data, for recent periods.

-- Explanations of relationships and changes in the data, such as key changes in amounts in the historical financial statements and nonfinancial statistics and the reasons for those changes.

-- Measures of liquidity and reasons for changes in those measures.

-- Identity and effect of unusual, infrequent or nonrecurring transactions and events.

Investors and creditors need forward-looking information on which to base their own projections. But they do not expect management to provide projections or forecasts.

They also want more information about operating opportunities and risks that are relatively near-term and relatively certain and quantifiable.

Users consider it essential that companies disclose forward-looking information, such as the identity of key trends and relationships in the data. They also seek other forward-looking information like measures of leading indicators -- for example, backlog and innovation.

Both investors and creditors consider forward-looking information an important part of their analysis, using it to assess variability of the operation, debt service capability, additional borrowing needs, management goals and strategies and future revenues. They welcome qualitative information, such as broad business objectives and prospects for return on assets and equity. But they are only interested in key indicators, as opposed to full forecasted financial information.

Users want operating opportunities and risks identified based on the company and its segments rather than on an industry-wide basis. They also want information about opportunities and risks resulting from concentrations in assets, customers and suppliers.

Information about a company that is consistent over time is valued more highly than information that is comparable between two or more companies -- but both are significant.

Users believe they can compensate for noncomparabilities resulting from differences in accounting between companies if they can obtain information that enables them to understand the differences and interpret them within an acceptable range. They believe differences in accounting principles and methods of application should be permitted as long as there is disclosure. They are concerned, however, about information gaps resulting from the accounting effects of unique events, such as business combinations accounted for by the purchase method and changes in accounting principles.

A change in accounting principle tends to destroy the comparability of data before and after the change. Even if standard setters require restatement, users may be provided with only three comparable income statements and two comparable balance sheets. Some companies take the time to assist users to understand the pre- and post-change data. Generally, however, users say that they lose the ability to analyze trends over a long period of time.

Credibility of reporting is a serious problem. Investors, creditors and their advisors believe that the reports of many companies reflect the natural tendency of management to report information in the best possible light and to avoid reporting poor company performance.

Users believe, for example, that managements sometimes report unusual losses as nonrecurring, while reporting unusual gains as events in the normal course of business.

Although investors and creditors do not believe that, in general, managements intentionally present misleading information, they believe that much of the information companies disseminate is too promotional and that troubled companies take great pains to convey the impression that they are not seriously troubled.

Users believe audited information has value because auditors provide independent assurance of the reliability of amounts reported and accompanying disclosures.

They would like auditors to provide additional qualitative commentary in their reporting.

Users believe the value of the services auditors provide is directly related to the ability of auditors to be independent of management, and they have expressed concerns about pressures on auditors' independence.

The standard audit report serves as a useful benchmark, but auditors should provide additional qualitative commentary in areas that would assist users in evaluating the quality of a company's earnings. For example, users would like commentary on the:

-- Audit scope and findings.

-- Entity's accounting and reporting practices in relation to alternative accounting methods.

-- Reasonableness of significant assumptions and estimates used in the preparation of its financial statements.

-- Risks associated with realizing recorded assets.

Users also believe that there is a need for increased independent auditor focus on internal controls.

Timeliness

In concept, users would like to receive relevant information as soon as possible. Timely information often provides an early warning of changes in conditions, and the timeliness of information is becoming more critical as the rate of change in the business environment accelerates. As a practical matter, however, users believe quarterly reporting is optimal -- except for information about critical transactions and events, which they need to have updated immediately.

Harmonization

Most users favor the use of one set of accounting standards by all foreign companies wishing to raise capital in the United States. They are not opposed to changing U.S. GAAP to conform to an international standard, but only if it represents an improvement over existing U.S. GAAP.

Interim Reporting

Users want more interim information than is currently provided, but not necessarily as much as is provided in full financial statements. Suggested additional information includes segment information; key captions of the balance sheet, income statement and cash flow statement; and standardized debt and book value ratios.

The Committee is developing recommendations for changes that are responsive to the findings of its research on users' needs. In developing its recommendations, the Special Committee will be mindful of cost-benefit considerations, including competitive and legal concerns.

The Committee has established the following guidelines as a framework for its recommendations:

-- Management should not be required to report information that would harm the company's competitive position.

-- The costs of preparing and attesting to information must be considered in relation to the benefits to users.

-- Management should not be required to report information about other companies; rather, it should focus on its expectations about how the environment may affect the company.

-- Management should be required to report only the information it knows. That is, management should not be required to search for information that it does not have, or need, to manage the business.

-- There must be legal safe harbors for management's disclosures of forward-looking information.

Before finalizing its recommendations, the Committee intends to conduct another, broader survey among users of financial information. It will also seek input from preparers. The purpose of these activities is to assure that the Committee's findings and preliminary recommendations are indeed responsive to users' needs and that they reflect appropriate cost-benefit considerations.

Special Committee on Financial Reporting

Edmund L. Jenkins, *Partner, Arthur Andersen, Chairman of the Special Committee*

Michael H. Sutton, Partner, *Deloitte & Touche, Vice Chairman of the Special Committee*

Lonnie A. Arnett, *Vice President and Controller, Bethlehem Steel Corporation*

Raymond J. Bromark, *Partner, Price Waterhouse*

Edmund Coulson, *Partner, Ernst & Young*

Robert K. Elliott, *Partner, KPMG Peat Marwick*

Larry Grinstead, *Partner, Baird Kurtz & Dobson*

William W. Holder, *Ernst & Young Professor of Accounting, University of Southern California*

Robert L. Israeloff, *Partner, Israeloff, Trattner and Co.*

Gaylen N. Larson, *Group Vice President, Household International, Inc.*

Joseph D. Lhotka, *Partner, Clifton, Gundersen & Co.*

James C. Meehan, *Partner, Coopers & Lybrand (1991-1992)*

Harold L. Monk, Jr., *Partner, Davis Monk & Co.*

Edward F. Rockman, *Partner, Alpern Rosenthal & Co.*

Barry N. Winograd, *Partner, Coopers & Lybrand (Member beginning 1993)*

A member of the FASB and a member of the SEC staff observe Committee meetings. Extensive staff support is provided by the AICPA, the FASB and the Committee members' firms. The Committee has also engaged several academics to undertake research and otherwise support its activities.

AICPA
American Institute of Certified Public Accountants

For more information
on the AICPA Special Committee please contact:

Paul Rosenfield
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Telephone 212-596-6156